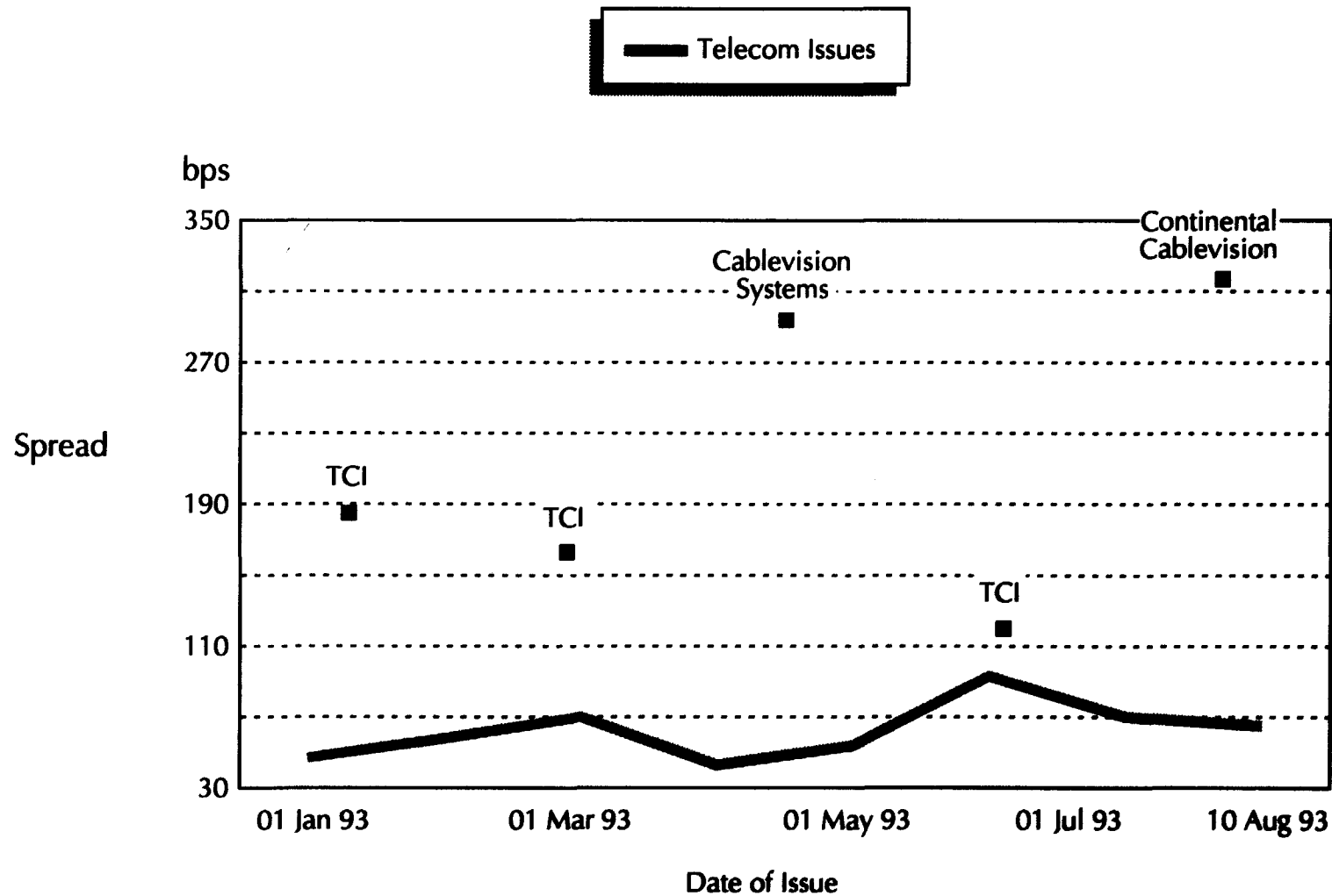


Comparison of Recent Spreads to Thirty Year Treasury



Source: Morgan Stanley & Co., Incorporated

Debt is the least risky form of investment which may be made in a firm. As have other capital-intensive industries in their early growth stages, cable has historically operated with a highly leveraged balance sheet, and therefore has a considerably higher debt/equity ratio than telephone firms. In Chart 2-A "Comparison of Historical Spreads to Ten Year Treasury" the risk differential between public cable and telephone debt and 10-year government bonds is shown.^{37/} This is the most pertinent comparison even though more telephone debt is in fact issued for significantly longer maturities. Cable companies are currently not able to readily issue debt for terms as long as the telephone companies (and it might be imprudent for telcos to utilize debt instruments that were less efficient for their own needs). But the quantifiable differences in these risk premiums present only a partial picture.

Continental's debt, like those of most other cable operators, also is subject to rigorous and lengthy performance covenants -- far more restrictive than those associated with telephone company debt. Exhibit C to Continental's comments shows the covenants associated with its August 6, 1993 debt

^{37/} Chart 2-B "Comparison of Recent Spreads to Thirty Year Treasury" shows the spread between telephone debt and cable debt issued in 1993. Chart 2-B not only shows the same type of spread, overall, it also shows that issuances by different operators -- even the same operator -- have varied significantly in 1993 alone.

offering as compared to the covenants found in recent Form S-3 SEC Registration Statements for BellSouth, New England Telephone and GTE. The differences in these provisions are dramatic. The public market requires the Bell Companies to offer primarily "negative pledge" covenants, which are among the simplest and least restrictive types of conditions."^{38/} Negative pledges do not address the financial performance of the issuer nor rights in the issuers in the event such financial parameters are violated. Exhibit C also contains the comparable conditions related to Continental's August 6, 1993 issuance of senior notes and debentures. Negative covenants required in these securities include restrictions on the payment of dividends, limitations on such things as indebtedness, investments in certain subsidiaries, transactions with affiliates, merger or sales of assets and other requirements entirely foreign to any RBOC or GTE debt offering.

^{38/} See BellSouth Form S-3, Article 4, particularly Section 4.03; and GTE Form S-3 Sections 4.05 and 4.06.

In addition to the wide swings in the cost of capital to cable, and the significant restrictions on use of such capital, other factors that are relatively unique to the cable industry must be factored into the risk calculus. Cable investments, both debt and equity, have even more variable yields when differences between individual firms are measured.^{39/} Of course, the cable industry also is far less mature than many industries subject to some form of rate of return regulation.

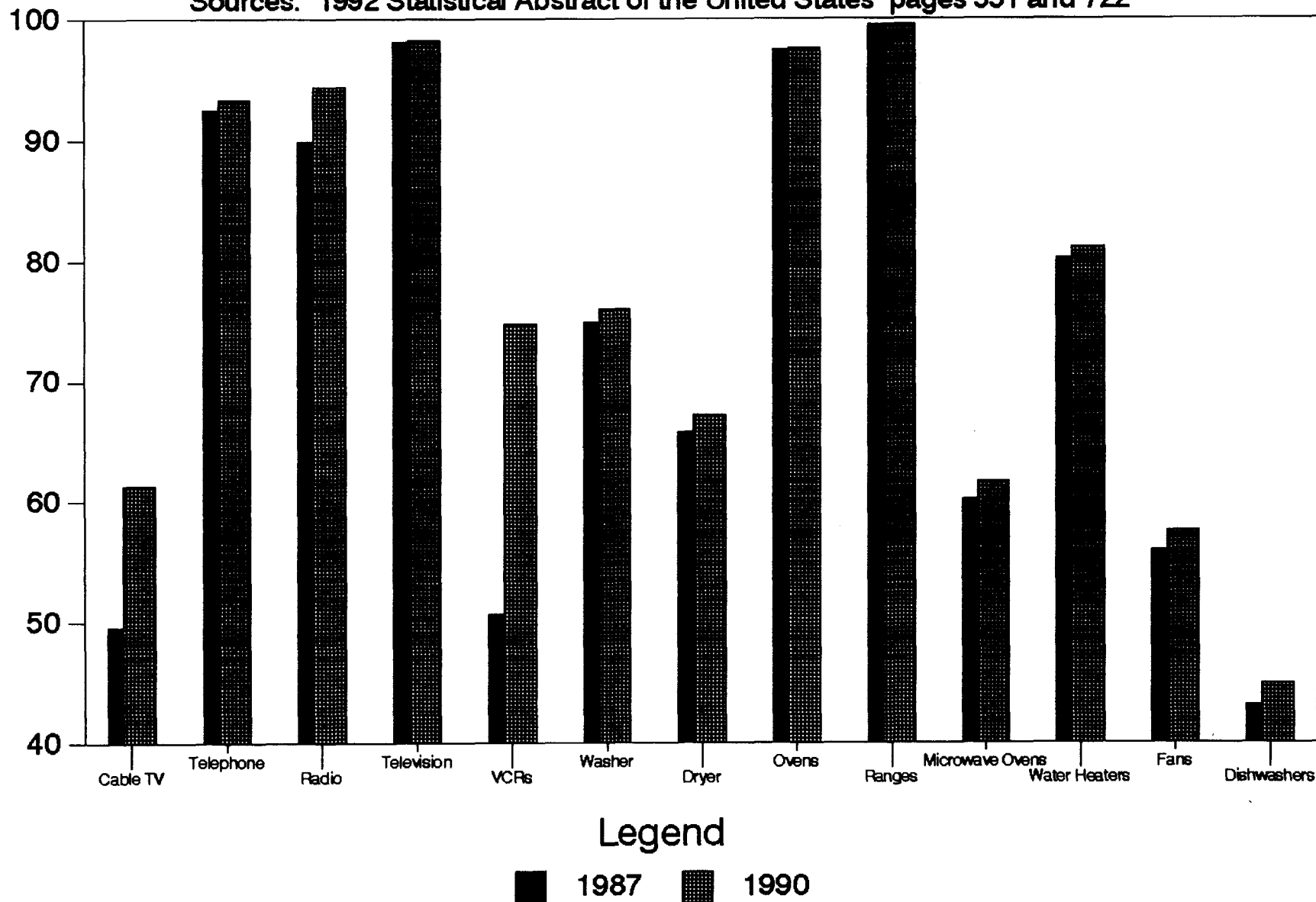
40/

39/ Another salient factor regarding this issue is that a regulator is obligated to establish a return that is fair for individual regulated companies not simply for the cable industry as a whole. This distinction may not be important with respect to the interstate services of Commission-regulated telephone companies. All of the Tier I local carriers that the Commission has used to establish an industry-wide return are large, very mature companies with unusually similar financial structures, business risks and capital market performance. Smaller telephone companies, many of whom had REA-subsidized loans, might well have benefitted by the Commission's use of the largest telephone companies and historically supported this method. This is not the case with the more diverse, less mature companies in the cable industry.

40/ Chart 3 "Household Penetration Rates for Consumer Goods & Services" illustrates that the cable industry as a whole has penetrated fewer households than many other types of consumer goods and services. Penetration rates for individual franchises and systems also is subject to substantial variation, with consequently different effects on a system's investment or rebuilding requirements and on its cash flow. Penetration percentages among Continental's systems, for example, range from the low 20's in Los Angeles, California, to the mid 80's in older classic markets.

Household Penetration Rates for Consumer Goods and Services

Sources: 1992 Statistical Abstract of the United States pages 551 and 722



These conditions create the greater risk associated with cable investments compared with telephone investments and to investments in broader portfolios of stocks like the S&P 400.

When one considers the quantitative and qualitative differences in cable industry risks, along with the obligation that a return be fair to the individual regulated firm, the serious problems with several proposals outlined in the Notice becomes apparent.

B. DCF Methodology Cannot Be Applied to Cable

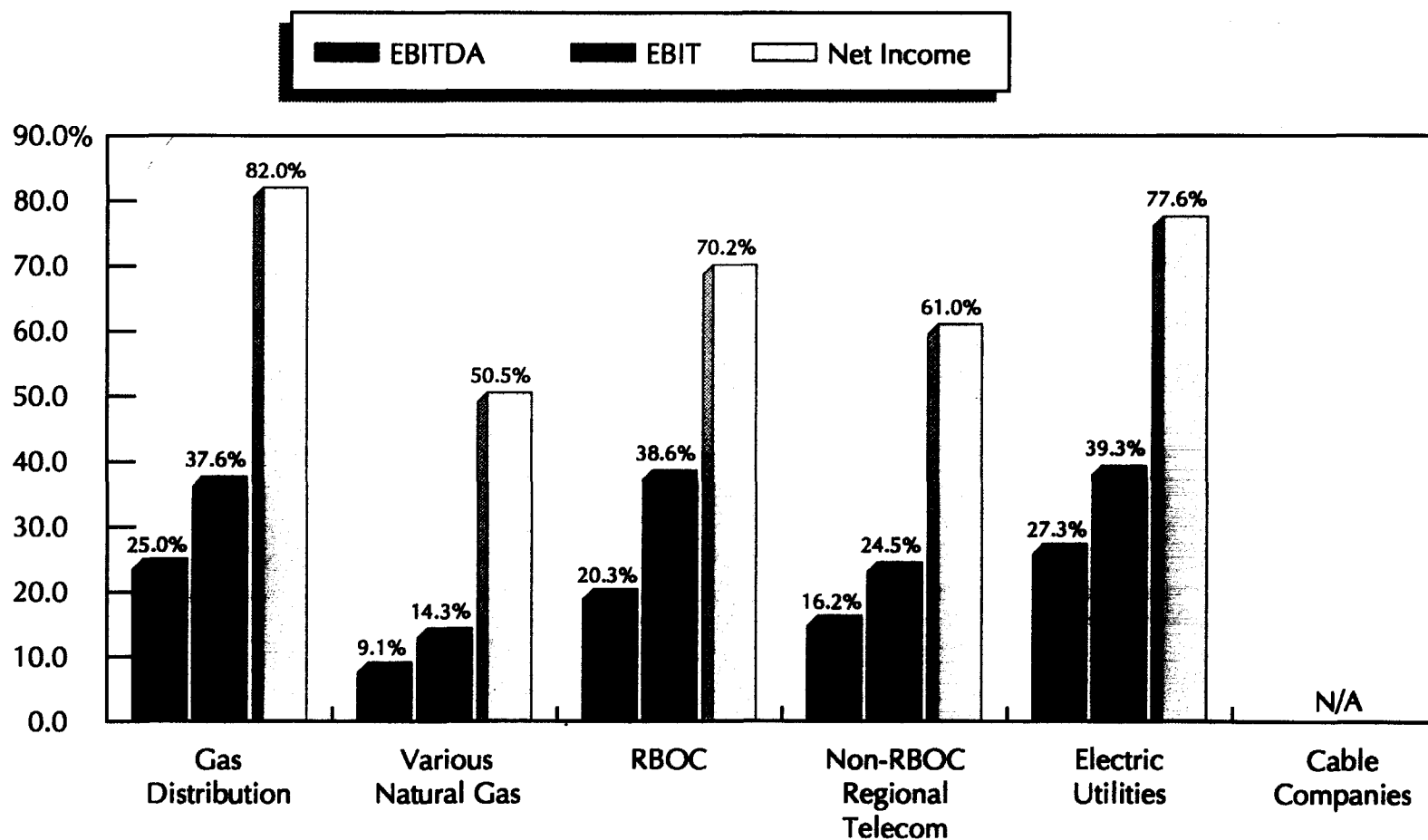
The Notice [¶¶ 51 - 52] proposes to apply the same type of discounted cash flow (DCF) methodology for setting an industry-wide return for cable as the Commission has done for LECs.^{41/} The DCF methodology used by the Commission in establishing authorized telephone rates of return, and used for other public utilities will not work for cable. Cable has no dividend history and many cable companies have negative net worth, a condition which is non-existent in other regulated industries. Chart 4 "Common Dividends as a Percent of EBITDA, EBIT, Net Income" compares dividends paid during the quarter ended March 31, 1993 by several groups of regulated entities,

^{41/} See Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, 5 FCC Rcd. 7193 (1990), recon. denied, 6 FCC Rcd. 7193 (1991).

compared to cable companies. As a percent of net income, earnings plus income taxes (EBIT), or earnings plus taxes and annual capital recovery accruals (EBITDA), the differences are quite clear. The DCF methodology simply does not work for the cable industry.

Common Dividends as a Percent of EBITDA, EBIT, Net Income

As of March 31, 1993



Source: Morgan Stanley & Co., Incorporated

C. "Surrogate" Costs of Debt Cannot Be Applied to Cable

By the same token, the Notice's tentative conclusion that a cable firm's debt costs can be measured against a multiple firm surrogate [¶ 53] is not applicable. The traditional practice of most regulatory agencies, including this Commission, with respect to local exchange carriers, has been to measure the actual cost of debt for the firm or industry subject to the rate of return prescription, not a debt cost for a surrogate set of so-called comparable industries. Comparable firms, industries or measures of financial performance are used in order to establish the regulatory cost of equity only because direct examination of these equity costs is not possible, as the Commission noted (NPRM ¶51). The cost of debt for individual cable companies is readily available.

D. The Investment Cycle Method Cannot Be Applied to Cable

Finally, the diversity of the cable industry and in the capital market performance of even the larger cable operators suggests why two other proposals regarding rate of return are not appropriate. The Notice raises the possibility of using an "investment cycle" approach to measure rates of return and other financial performance. [¶ 56] Under an investment cycle approach, the cable operator's fair return of, say, 15% might be

interpreted to mean that if the operator eventually earned 15% it would be made whole. A significant requirement of establishing a return is to assure a present opportunity for return. The return opportunity is not guaranteed, but, likewise the return duly found to be reasonable cannot be put off in time. In a rate regulated environment, there is no basis for deferring a cable operator's realization of the opportunity to earn a current return. The "investment cycle" approach would mean that the current FCC or local regulator was placing itself in the position of guaranteeing a future return higher than 15% would be realized by cable investors in exchange for a return of 10%, 5% or even zero today. Only this type of guarantee would result in the appropriate average return over the so-called investment cycle. Since such a future binding guarantee is impossible, this approach breaks down.

The investment cycle approach also is antithetical to the public interest -- and the cable operator's own marketing interest -- in rate stability. Future rate levels would be adversely impacted if the cost of capital increased because the amount needed to make up the earnings deficiency in early years of the investment cycle would be increased. Finally, the investment cycle approach would be complex and administratively inefficient, because the "investment cycle" will be different for different franchises or systems; it will certainly differ depending upon the timing of rebuilds, remaining franchise time

period, and market conditions (like the growth of competition, etc.). Continental's one-time transition adjustment will eliminate the need for such complexities.

Likewise, while the Commission may be correct that some types of cash flow analyses would not provide stable or correct indicators of financial performance [¶ 54], the supposition that cash outlays representing loan amortization may be characterized as "positive earnings" confuses the return of capital with a fair return on capital, and is therefore incorrect.

E. Continental's Recommended Risk Premium Approach

It follows from the above that the proposed rate of return approach in the Notice involving use of the classical DCF calculations is fraught with problems. The Notice states [¶ 51, n. 55] that a risk premium approach generally has not been favored by regulators for traditional public utilities. Continental believes that the Commission's observation turns more on chance than on deliberate choice. Most regulatory agencies at the state level are able to set rates of return in individualized evidentiary proceedings that concern only one regulated firm or closely affiliated firms. In such circumstances, a risk premium approach that might be marginally less precise might not be required. Here, on the other hand, a more flexible approach that is able to account for all sources of risk premiums, including both spot differentials in expected yields and the restrictions

imposed on cable's capital, is warranted. Continental urges the Commission to reconsider its apparent disinclination to use a risk premium approach.

Continental believes that the Commission should adopt a risk premium approach modifying the basic approach set forth in ¶52 to account for the specialized risk factors in the cable industry.^{42/} The appropriate method for establishing the cable industry's rate of return, will involve a hybrid of methodologies, like that outlined in paragraph 52 of the Notice. The approach should avoid the infirmities of the orthodox DCF approach. It should fully reflect the risk spreads typical of cable debts compared to either Aa corporate debt or risk free debt securities, as illustrated in Morgan Stanley Charts 1, 2-A and 2-B above.

The cost of debt is available for the cable industry as a whole and for specific cable operators. Interest rates on such debt are established under rigorous arms-length conditions. Debt costs are the most readily ascertainable measure of capital costs available. To facilitate the Commission's analysis, public debt costs could be utilized.

^{42/} In the future the Commission will gather additional data that will enhance this approach. These data will indicate the effects of the rate of return on reinvestment in infrastructure, [¶47], and provide more information with respect to the growing number of cable companies facing new forms of video and information competition.

The significant risk spreads needed to sell cable debt should be imputed as well to the baseline costs of equity. That is, the cost of equity -- determined from any set of comparable companies in the media, entertainment and like industries and from the comparable set of S&P 400 companies -- should meet two threshold tests: It should fully account for the nominal average risk premiums imposed on cable debt offerings over time, and it should include an additive factor to recognize features specific to cable financing. These factors are (a) the historical volatility in the spot (i.e. current) costs of both cable debt and cable equity, a factor that could be lost if the Commission relied only on data averaged over broader time periods to make its return prescription; (b) the strict and confining sets of covenants to which operators like Continental are bound, unlike most rate of return-regulated firms; (c) the fact that inter-company volatility in debt and equity costs is greater among individual cable operators, over time, than in many otherwise "comparable" sets of companies; and (d) the fact that cable operators historically have reinvested in infrastructure and should be provided the incentive to continue to do so.

In other words, the cable risk premium as determined over time should be established at or above the average level, in order to account for industry and company volatility and the effect of restrictive terms and conditions on the financial flexibility of cable operators. Another way to account for these

unique factors in the cable industry is to allow cable operators to move their capital structures towards a more reasonable, objective balance of debt and equity. By adopting a risk premium approach, and establishing the equity return differential in this manner, the Commission will (a) accurately map actual financial risks, (b) simplify its rate process, and, (c) assure that individual cable companies have the opportunity to earn a fair return and compensation for capital invested in their unique environments.

VI. ACCOUNTING & ALLOCATIONS

A. Accounting Level

Continental's accounting records generally are not kept on a system (i.e., headend) or franchise level basis. Profit and loss statements are maintained at the operation's unit level. Continental has 550 franchises, 145 systems (defined by headend) and 65 operations units. In most cases, these operations units embrace multiple systems and franchises. Fiber interconnected headends, centralized customer service and regional repair facilities serve large regions; management groups take responsibilities for multi-state regions and report costs in accounting centers which transcend system and state lines.

Increasingly, both operations units and systems are being consolidated to improve customer service and other

operating functions and to reduce costs. For example, a large operations unit can usually support longer hours of operation and more sophisticated telephone/computer systems than a smaller office can and therefore such larger unit can offer better customer service. Future flexibility is likewise important as cable operations evolve. Like most businesses, the operations unit is fixed as the initial level of management accountability and accordingly the level at which budgets are required. The budgetary level records only revenues and expenses through operating income, and certain balance sheet items such as receivables, inventory, property, plant and equipment, and certain accruals. The operations units employ, in effect, just single entry bookkeeping for management responsibility purposes.

Continental currently maintains a complete balance sheet and income statement through net income (e.g., depreciation, amortization, interest, etc.) on a legal entity level i.e., company level. (Companies are usually a consolidation of several operations units under one legal entity such a Continental Cablevision of Broward County, Inc.). Double entry bookkeeping is done for each company. Continental has approximately 50 such legal entities.

Some costs, such as property taxes, franchise fees and other special assessments can easily be assigned to a specific franchise. But if Continental were required to maintain detailed

accounting records of all costs at the franchise or system level, it would substantially increase costs of doing business and be inconsistent with efforts to consolidate operations and improve customer service. More people and computers would be required to record, track, enter and report on transactions at the franchise or system level.

Because these types of allocations would be imposed solely for regulatory purposes, Continental believes that it would be better policy to allow operators to continue to maintain their financial statements at current organizational levels and to make future adjustments as operations are consolidated. The policy should also permit averaging of costs across several franchises, systems and, where appropriate, regions.

Just as a major telephone study area is always statewide, and an RBOC is permitted to average interstate access across state lines, cable should be granted the same administrative convenience, and be permitted (but not required) to average costs across reasonable asset groups. Where cost averaging occurs, the operator should be permitted to determine the appropriate level where aggregation or cost averaging occurs. It is the operator who has maintained the books and determined organizational structure and responsibilities. The operator is therefore in the best position in the first instance to select the level of cost averaging. This is particularly important

because cable continues to experience technical and organizational changes that affect accounting practices. For example, headend consolidation and interconnection of previously stand-alone systems has an impact on capital costs and salary allocations for engineering staff. To permit franchising authorities to select the level of cost averaging could potentially politicize these decisions, or at a minimum require additional accounting work, particularly if different franchising authorities selected different levels of cost averaging. Cost averaging cannot simply be limited to community units with the same tiers, services and franchise fees, and certainly not conditioned on consent of the franchising authority. Cost of service studies will be complex enough without multiplying their number and introducing artificial allocations. Costs may eventually be allocated by reasonable allocators to account for differences in services; but they should be permitted to be averaged at higher levels to ease the administrative burden of regulation.

There are ample checks in place to prevent abuse of such flexibility by cable operators. There are only a limited number of allocators that are likely to be used, because cable operators only have data on relatively broad allocators such as channels, subscribers, and plant statistics. Eventually Continental expects the FCC to focus on well-defined outputs and compare the results among many operators. The FCC will have

sufficient observations so that it should not have to rely upon strict regulation of all input data, such as prescribing a full system of uniform accounts and charts and allocation rules. In the meantime, we agree with the Commission's observations [¶ 58] in large measure, that records required by GAAP, etc. will provide a suitable audit trail for an operator's data. Uniform rules on major accounting issues, like capitalization and amortization policy will aid both industry and regulators, but uniformity should not extend to chart of account detail, or to an operator's GAAP-complaint accounting practices in less significant areas.

Given these existing checks, the FCC should allow cable operators to average data across multiple franchises for purposes of rate regulation. This will promote significant savings in FCC resources and administrative burdens on operators who choose rate and cost averaging. Subscribers would benefit from having faster FCC decisions and fewer costs of operator regulatory compliance.

B. "Tier Neutrality" and Cost Allocations

The FCC's concept of tier neutrality is manifested both by the development of the "unitary" rate benchmarks and by the possible condition that any cost of service showing which seeks to justify rates different from the benchmarks for one regulated service tier must also justify rates different from the benchmark for the tier regulated by the other jurisdiction (i.e., FCC or local authority).

If the principle of "tier neutrality" is intended to require that cost of service showings be made both at the FCC and municipal level, then the Commission's suggestion is severely flawed. If the Commission's concern is that a COS rate on one tier and a benchmark rate on the other will create a higher return than would be authorized by COS or benchmarks alone, there is a ready solution. The Commission could require that any operator who elects cost of service with respect to cable programming service demonstrate that its overall return for basic and cable programming service is reasonable. This can be readily presented by an operator, because cost of service showings will necessarily include allocations of costs across channels, and the cost-based rate for each tier may be compared with both the benchmark rate and the rates currently charged.

Fundamentally, the FCC's rigorous insistence on "tier-neutrality" is bad public policy because it is not cost based. For example, Continental's actual costs for cable programming services are greater, channel for channel, than the costs of basic service. Likewise, marketing costs are more directly attributable to cable programming service tiers than to basic service. In 1992, Continental systems spent \$63 million in direct marketing expenses. Virtually all of this amount was devoted to selling cable programming services and premium services. The Act itself requires cable operators to sell basic as a mandatory buy through to reach any other tier, and requires

the Commission to adopt minimum marketing requirements with respect to basic. Neither of those rules would be required if basic were marketed as heavily, channel for channel, as satellite tiers. Because it is not cost based, i.e., because programming and other costs vary between tiers, "tier neutrality" creates losses in consumer welfare and actually reduces economic efficiency. Thus, the current approach is both overbroad and economically inefficient.

There is no fundamental reason that the Commission cannot permit a franchising authority to approve a benchmark rate while the Commission considers a cost of service showing for cable programming services. The Commission already has held that an operator is permitted to charge less than the maximum rate, and (assuming rational behavior) benchmarks may be assumed to be beneath the COS rate pursued by an operator. Jurisdictional divisions are commonplace in telephone regulation. For example, the Commission has accepted the fact that under §2(b) of the Communications Act, state PSCs may prescribe different depreciation rates than does the FCC, for the same physical plant. For another example, the Commission never has suggested that an LEC would be prohibited from following FCC price caps for interstate access if the state PSC continued to apply rate of return regulation to intrastate service.

Particularly in the first few years of cost of service regulation, the Commission should avoid mandating inflexible methods of allocating costs among tiers. For example, allocating costs strictly on the number of subscribers will have distorting effects on the rates in less mature systems. Allocating costs strictly by number of channels will become problematic over time with the introduction of new digital compression technology. If the cost allocation relied upon channel allocations of joint and common costs, increases in a system's channel capacity using digital compression could artificially suppress legitimate basic service cost allocations. This result will certainly not produce a fair and reasonable rate for the basic service tier, particularly because the added channel capacity created by compression will be used primarily for a la carte channels priced on a per-channel basis, and likely appealing to increasingly specialized, smaller numbers of viewers.

These anomalies can be avoided in several ways: Channel-based cost allocations could, for example, exclude channels devoted to programming priced on a per-channel or per-event basis. Channel-based cost allocators could be weighted for actual household subscription levels so that channels devoted to relatively few subscribing households (e.g., premium or pay-per-view) would not bear a disproportionate share of costs. Alternatively, the capacity of various systems could be set at fixed reference indicators, similar to how the Commission treats

digitally multiplexed telephone lines for rate regulation.^{43/}

The same checks which permit Commission flexibility to allow cost of service showings at higher accounting levels than system or franchise should also permit flexibility in cost allocation. Only a limited number of allocators are likely to be used; GAAP records will provide a suitable audit trail; and eventually the Commission will be able to focus on well defined outputs to compare the results among many operators.

C. Operating Expenses And Programming Costs

The Commission suggests (§24, n.25) that certain expenses might be automatically disallowed for rate making purposes. Many of the expenses catalogued for exclusion are in fact appropriate for inclusion in the cable television rate base. Unlike public utility companies, cable television operators do not enjoy universal penetration, and experience high costs to attract and retain a stable subscriber base. See Part III. Also unlike public utility companies, cable operators must periodically renew their franchises (in order to retain their right to do business), provide community-based programming and strive to deliver programming content which is responsive to

^{43/} For example, DS1 digital telephone lines are fixed at a ratio of 24 voice bandwidth-equivalent channels, although with the same types of digital compression techniques utilized by the cable industry, a DS1 can readily supply three to four times more channels on the same facility.

community needs. Thus, charitable expenses, club fees and other money expended within the franchise community should be allowed as a necessary operating expense in fulfilling the quite different role of cable television.^{44/}

Other accounting concerns set forth in Continental's January 27, 1993 Comments in MM Docket 92-266, App. A, are incorporated herein by reference.

VII. DEPRECIATION PRESCRIPTIONS

"Depreciation accounting" purports to balance capital consumption against capital revenues by spreading an asset's depreciation costs over its useful life. It serves to distribute equitably throughout the several years of service life the only expense of plant retirement which is capable of reasonable ascertainment -- the known cost less the estimated salvage value.^{45/} In essence, depreciation accounts for the loss of service value of a capital asset as a result of wear and tear as well as technological obsolescence.^{46/} Regulated common carriers

^{44/} Continental agrees that programming expenses should be treated as a recoverable operating expense and not added to rate base, provided that the Commission properly adjusts the rate base to account for start-up losses and deferred returns.

^{45/} Louisiana Pub. Serv. Comm'n. v. F.C.C., 476 U.S. 355, 364 (1986).

^{46/} 47 C.F.R. §32.9000 (defining depreciation); Louisiana Pub. Serv. Comm'n., 476 U.S. at 364.

can recover depreciation dollar for dollar as an element of their expense items to be added in the calculation determined revenue requirements. Pursuant to Commission practice, LECs submit triennial depreciation rate studies utilizing historical analysis predictions as to future technological developments to establish depreciation rates for particular accounts and overall composite rates for the entirety of the telephone company's plant.

Continental generally concurs with the Commission's view that the remaining life method is the most appropriate means of depreciating cable plant, but putting cable into the same telco triennial review would be of no value whatsoever. Calculating remaining life for cable is extremely difficult today. Cable television is in the midst of three simultaneous revolutions: (1) the conversion from analog to digital signalling; (2) the transition from coaxial cable to fiber; (3) the renewal of the vast bulk of franchises issued during the late 1970's and early 1980's. Cable assets must be reevaluated periodically to determine if the expected useful life of an asset has changed, not just due to physical obsolescence but due to technological obsolescence as well. Long amortization periods typically associated with GAAP are premised on the accounting assumption that the business will continue in perpetuity. The assumption may have been appropriate for utilities and telephone companies, but they are hardly applicable to cable television franchises, which typically run for 10-15 years, and carry with

them the risk of non-renewal and the near certainty that the conditions of renewal will be technologically and materially demanding.

Other fundamental characteristics of the cable industry preclude easy reliance on telephone depreciation prescriptions. Cable places heavy reliance on customer premises equipment ("CPE"). Converters are an integral part of the transport structure, as they enable cable operators to make use of distribution bandwidth which is otherwise not receivable by older receivers, and to upgrade to greater channel capacity without awaiting the relatively long (7-15 year) replacement cycle of embedded television receivers. Similarly, converters are an essential element of cable's security, as well as a means for packaging products into tiers which offer consumers choice of services. Continental's investment in CPE is approximately 13% of its total property, plant and equipment ("PPE"), compared with the telephone industry, where CPE is 0% of PPE. For this reason alone, the overall composite rate of depreciation should be greater than the LECs.

Another fundamental characteristic of cable television plant which must be accounted for in depreciation rates is the high rate of theft and loss. Cable CPE, particularly converters, suffer a loss and theft rate of approximately 3%, compared with a telephone uncollectible rate of slightly over 1%.^{47/} Continental

^{47/} In 1991, 1.16% of gross operation revenues billed by LECs were uncollectible (1.1% for the RBOCs). Statistics of Common Carriers, Table 2.9, lines 5300 and 530 (1991).